The Fat Controller – Slimming Down the Excesses of Controlling Shareholders in UK Listed Companies

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Abstract- It has become fashionable to extoll the benefits of an incumbent controlling shareholder in companies. Indeed, many of the failures of the stewardship movement, that encourages shareholders in UK listed companies to take an interventionist approach to their investments, have been blamed on the prevalence of dispersed and fragmented ownership models. However, in the publicly listed company sphere, it is debatable whether the virtues of controlling shareholders outweigh the potential detriments, as evidenced by the corporate governance travails of Sports Direct International plc. This paper summarises the principal inherent benefits and detriments, and how these may have presented themselves in the experience of Sports Direct International plc; followed by a normative analysis of the effectiveness of certain regulations ostensibly created to constrain controlling shareholders, together with proposals for reform, arguing that the existing regulations have proved to be insufficient in constraining the controlling shareholder of Sports Direct International plc.

Keywords- Controlling shareholders, Sports Direct, Independent directors, Related party transactions, Listing Rules, Corporate Governance Code

1. *Introduction*

The 'Fat Controller' was a benevolent influence in a popular series of children's books.[1] However, in the context of a listed company, the presence of a controller, being a single shareholder or related group of shareholders with sufficient control to definitively influence the composition of the board of directors (and therefore the ability to have a fundamental influence on the appointment and removal of managers) may not be unequivocally benign. Such a shareholder, a 'controlling shareholder' for the purposes of this paper, is able to exercise such influence either legally (through holding a majority

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[1] The Railway Series of books by the Rev. W. V. Awdry.

of the votes in the company), or 'effectively' (by holding such a high proportion of the votes in the company that, although below 50 per cent, it has effective influence over the board given the dispersed nature of the remainder of the shares in the company). Controlling shareholders come in a variety of forms, whether individuals, companies or public bodies, management or non-management investors, or founders, families or heirs.

Sports Direct International plc (Sports Direct) is a prominent example of a listed controlling shareholder company. The company was founded in 1982 by Mike Ashley, and obtained a premium-listing on the Main Market of the London Stock Exchange (LSE) in 2007. Upon listing, Ashley retained control of the company - as of the end of the company's 2016 financial year, he owned 55.14 per cent of the shares in the company,[2] and, therefore, was, and still is, a true controlling shareholder with the ability to determine the composition of the board.[3] For a while, the company realised considerable success, becoming a member of the FTSE-100.[4] However, a variety of controversies have tarnished the company's name in more recent years, exacerbating share price declines. 2015 was an especially tumultuous year in the history of Sports Direct. After a media exposé, the company was accused of poor employee working conditions, as well as illegalities relating to minimum wage breaches and insufficient redundancy consultations. Matters did not improve in 2016, with allegations of nepotism arising as a result of transactions with family members of Ashley coming to light, as well as a minority shareholder revolt relating to the re-election of the company's chairman and longstanding absence of a permanent finance director. More recently, further controversy transpired when the company attempted to make a £11m payment to Ashely's brother for past service.[5] Many

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[2] Sports Direct's Annual Report and Accounts for the financial year ended 24 April 2016 (Sports Direct's 2016 Accounts) at 45.

[3] Under the Companies Act 2006, s 168, directors may be removed from office by the passing of an ordinary resolution, which is, pursuant to the Companies Act 2006, s 282, a resolution that is passed by a simple majority. Additionally, the articles of association of Sports Direct (at articles 103 and 104) specify that directors may be appointed by ordinary resolution, or by resolution of the board (provided that, in the latter case, such director retires at the subsequent annual general meeting, subject to re-appointment by ordinary resolution).

[4] The 100 largest companies by market capitalisation as maintained by a subsidiary of the London Stock Exchange.

[5] The payment was eventually abandoned after objection from the minority shareholders (RNS Number: 2530Z, 13 December 2017).

institutional investors have blamed the problems at Sports Direct on Ashley's unchecked power and influence as a controlling shareholder.[6] Indeed, the chief executive of Manifest, the shareholder stewardship and engagement consultancy, agitated that: 'Had Mike Ashley listened to shareholders four or five years ago, we might not be in the situation we're in at the moment.'[7] Perhaps institutional investors should not have been particularly surprised, given that they were warned of the potential for such a scenario – the February 2007 prospectus for the initial public offering of Sports Direct stated, 'The interests of the Shareholder [Ashley] may conflict with those of the public shareholders.'[8] This stark warning was repeated and alluded to throughout the prospectus. An element of *caveat emptor* therefore applies to the laments of institutional shareholders, but should the minority shareholders, and perhaps broader stakeholder groups, have been better protected by regulation? Taking into account the various corporate governance failures at Sports Direct in particular, this paper will look at the theoretical detriments of an incumbent controlling shareholder in the listed company sphere, and contrast these with the potential benefits, before scrutinising the fitness of certain existing regulatory protections against the impropriety of controlling shareholders, and proposing reform in relation thereto.

[6] See: Andrea Felsted, David Oakley and Andy Sharman, 'Sports Direct's Mike Ashley walks away from bonus scheme' *Financial Times* (16 July 2014) <https://www.ft.com/content/669515ac-0caf-11e4-90fa-00144feabdc0>, and the publication by the Investment Association 'Adherence to the FRC's Stewardship Code at 30 September 2014 – Detailed practical examples' at 16-18. Unless otherwise stated, all URLs were last accessed on 10 July 2017.

[7] As reported by Rebecca Marston, 'Sports Direct: Ashley steps in as chief executive resigns' *BBC News* (23 September, 2016) <http://www.bbc.co.uk/news/business-37448915>.

[8] On page 8 of the prospectus, as reported by James Quinn, 'Sports Direct's investors shouldn't be surprised by recent events - the retailer was Mike Ashley's baby from the outset' *Telegraph* (7 September 2016) <http://www.telegraph.co.uk/business/2016/09/07/sports-directs-investors-shouldnt-be-surprised-by-recent-events/>.

2. The Controlling Shareholder Conundrum –

'Private Benefits of Control' v 'Reduction in Agency Costs'

In principle, it could be argued that a controlling shareholder should have the interests of minority shareholders at heart due to such controlling shareholder having the 'highest use value'[9] by virtue of being exposed by such a large shareholding. However, Ratner[10] eloquently dismissed this argument stating that it is akin to '*putting the lions in the same cage with the rabbits at the zoo, on the assumption that the lions will represent the rabbits' interests in negotiating with the keepers for food.*' This quote shows that clearly there is scepticism that controlling shareholders will 'behave' of their own volition, and that, in fact, the presence of a controlling shareholder in a listed company could be detrimental to the interests of the minority shareholders. More generally, the broad cynicism in relation to the notion of controlling shareholders, was elucidated by Holderness and Sheehan[11]: '*…although the reasons for the public's hostility are seldom specified, there is a vague notion that the voting power of large-block shareholders somehow harms small shareholders*'. The distrust of a controlling shareholder largely manifests itself in the potential that, since such controlling shareholder has substantial influence over the operations of the company, it could extract various private benefits to the detriment of the other minority shareholders; often referred to as 'private benefits of control'.

There are many ways in which a controlling shareholder can extract private benefits. The gamut of such private benefits of control have been discussed extensively in the literature, so will only be considered briefly herewith to the extent that they are relevant in the context of Sports Direct.

[9] P. Flocos, 'Toward a Liability Rule Approach to the "One Share, One Vote" Controversy: An Epitaph for the SEC's Rule 19c-4?' (1989-1990) 138 U. Pa. L. Rev. 1761, 1797; R. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2005-2006) 119 Harv. L. Rev. 1641, 1651; and J. Dammann, 'The Controlling Shareholder's General Duty of Care: A Dogma that should be Abandoned' (2015) 2 U. Ill. L. Rev. 479, 481.

[10] D. Ratner, 'The Government of Business Corporations: Critical Reflections on the Rule of One Share, One Vote' (1970-1971) 56 Cornell L. Rev. 1, 20.

[11] C. Holderness and D. Sheehan, 'The Role of Controlling Shareholders in Publicly Held Corporations: An Exploratory Analysis' (1988) 20 J. Financial Econ. 317, 318.

Perhaps the most egregious form of private benefit extraction is through what is euphemistically labeled 'tunneling'. [12] This is the 'the transfer of assets and profits out of firms for the benefit of those who control them'.[13] The most common form of tunneling is where the relevant company enters into transactions with other entities, in which the controlling shareholder usually owns a greater proportion of the cash flow rights, on non-arm's length terms unfavourable to the relevant company, effectively expropriating the minority shareholders in the relevant company. As is common with controlling shareholder firms, Sports Direct has entered into a number of transactions with entities linked to its controlling shareholder.[14] Notwithstanding assertions by Sports Direct that such transactions took place on arm's length terms,[15] thereby dismissing incidences of tunneling, certain transaction, including with Ashley's brother[16], have attracted significant suspicion. Another form of tunneling may occur if management itself holds a controlling stake in the relevant company, [17] through the award of excessive remuneration for such management[18] (although in the presence of non-management blockholders, such remuneration is attenuated).[19] The controversial 2015 bonus share scheme of Sports Direct is an example where minority shareholders were concerned that

[12] The more serious nature of tunneling was highlighted by R. Gilson and J. Gordon, 'Controlling Controlling Shareholders' (2003) 152 U. Pa. L. Rev. 785.

[13] S. Johnson et al, 'Tunneling' (2000) 90 Am. Econ. Rev. 22, 22. The authors attribute the genesis of the term to the expropriation of minority shareholders in the Czech Republic ('*as in removing assets through an underground tunnel*').

[14] n 97 and 98.

[15] Sports Direct's 2016 Accounts at 105.

[16] Sean Farrell, 'Sports Direct uses Mike Ashley's brother's firm for overseas distribution' *Guardian* (22 August 2016) <https://www.theguardian.com/business/2016/aug/22/sports-direct-pays-mike-ashleys-older-brother-international-delivery>. Sports Direct's auditors have claimed that the relevant transaction was not a 'related-party transaction' requiring disclosure in the accounts of the company, nor a transaction requiring shareholder approval – whether such a transaction raises concerns which regulation should limit will be considered in this article.

[17] It should be noted that Ashley continued on the board of Sports Direct after its listing, serving as the executive deputy chairman of the board until taking over the role of CEO.

[18] Holderness and Sheehan (n 11) 319.

[19] H. Mehran, 'Executive compensation structure, ownership, and firm performance' (1995) 38 J. Financial Econ. 163, 179; and M. Bertrand and S. Mullainathan, 'Do CEOs set their own pay? The ones without principals do' (2000) National Bureau of Economic Research, Working Paper 7604 March 2000 1, 29 and 35.

excessive remuneration would become payable to a controlling shareholder through his role as an executive director.

Another form of private benefit is especially prevalent where controlling shareholders are individuals or families, rather than corporate shareholders. In such a case, since a substantial portion of such shareholder's wealth may be tied-up in the relevant company, the controlling shareholder may dictate a diversification of the company's businesses in order to mitigate against the risks of being personally undiversified. Although it has been posited that even with dispersed ownership firms, companies, as they mature, become huge conglomerates of many unrelated businesses,[20] the situation is particularly common with controlling shareholder firms,[21] and such diversification may not necessarily be in the best interests of the minority shareholders who can themselves self-diversify by maintaining a varied portfolio. Sports Direct itself has diversified substantially over recent years, pursuing an acquisitive strategy expanding its business from sports retail and products to 'premium lifestyle brands', even moving beyond clothing.[22]

It is possible, however, that Sports Direct's expansion of its business empire is not related to a desire to diversify, but rather as a result of non-pecuniary private benefits. Although often academically neglected,[23] from the perspective of minority shareholders, non-pecuniary private benefits, as opposed to simple and direct financial extraction, can be particularly insidious, since there may be large incentives for controlling shareholders to sacrifice firm value in their pursuit.[24]

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[20] J. Galbraith, *The New Industrial State* (Princeton University Press (1967)) 92.

[21] See: B. Cheffins, 'Corporate Law and Ownership Structure: A Darwinian Link?' (2002) at 41 (available at SSRN: <http://ssrn.com/abstract=317661 or http://dx.doi.org/10.2139/ssrn.317661>).

[22] Sports Direct acquired interests in House of Fraser in 2014, and Findel plc in 2015 and 2016, followed by interests in Debenhams plc, French Connection Group plc, Agent Provocateur, and Game Digital plc in 2017.

[23] Gilson, (n 9) 1663.

[24] See: P. Gompers, J. Ishii, and A. Metrick, 'Extreme Governance: An Analysis of U.S. Dual-Class Firms in the United States' (2010) 23 Rev. Financial Stud. 1052, 1085 –'A Majority owner…can rationally…sacrifice firm value…to maintain [non-pecuniary] private benefits of control.'

Reputation and prestige, as well as the simple psychological worth of being in control[25] are obvious non-pecuniary benefits. It is impossible to ascertain the intentions of Ashley in shifting the Sports Direct focus to luxury brands and retail – it could stem from a desire to increase the success of the company by targeting a potentially more profitable sector to replace or supplement the ailing principal business, or from a desire to enhance reputation and prestige. What is indisputable is that such decisions are those of the controlling shareholder.

From a takeover perspective, since, palpably, an offeror can not take control without acquiring, in a consensual manner, the controlling shareholder's stake, value-enhancing takeovers will be blocked unless the controlling shareholder is compensated for the loss of private benefits. In certain jurisdictions, this leads to the payment by the bidder of a significant control premium for the controlling block held by the controlling shareholder, compared to the price paid to minorities. The ability of Ashley to extract such a premium is mitigated in the UK as a result of rules requiring that minority shareholders are treated equally.[26] However, the controlling shareholder may still block takeovers otherwise beneficial to the minority shareholders,[27] even if the private benefits the controlling shareholder wishes to retain are not financial, such as the endowment effect particularly applicable to individual or family controlling shareholders,[28] whereby sentiment, loyalty or paternalistic considerations dominate purely economic considerations.[29]

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[25] See: P. Aghion and P. Bolton, 'An Incomplete Contracts Approach to Financial Contracting' 59 Rev. Econ. Stud. 473, 476; and A. Dyck and L. Zingales, 'Private Benefits of Control: An International Comparison' (2004) Vol. LIX J. Finance 537, 540.

[26] Rule 9 of the Takeover Code as published by the UK's Panel on Takeovers and Mergers. Also see: Dyck and Zingales (ibid) 551.

[27] L. Bebchuk et al 'Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights' in R. Morck (ed), *Concentrated Corporate Ownership* (Chicago: The University of Chicago Press 2000) 295.

[28] See: R. Daniels and P. Halpern, 'Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy' (1996) 26 Can. Bus. L.J. 11, 20. For an economic description of the term 'endowment effect', see: D. Kahneman, *Thinking, Fast and Slow* (Farrar, Straus and Giroux, 2011) 289-299.

[29] Founders 'hanging-on' after their talents have waned, or transferring control to unsuited heirs can have a detrimental effect on firm performance (H. Cronqvist and M. Nilsson, 'Agency Costs of Controlling Minority Shareholders' (2003) 38 J. Financ. Quant. Anal. 695, 715).

The encumbrances posed by private benefits of control can be balanced against the positive aspects of controlling shareholders. In particular, agency costs in the form of self-serving activity by managers[30], which, as widely discussed academically,[31] often occur in the absence of adequate monitoring by shareholders, could be reduced. The presence of a controlling shareholder, as with Ashley at Sports Direct, should enhance monitoring of management, and therefore managerial accountability, given that management agency costs will have a significant impact on the value of the controlling shareholder's stake in the company (consequently, the controlling shareholder also enjoys a large share of the benefits gained by better monitoring). Controlling shareholders are also further incentivised to stringently monitor management and use their substantial voting capacity to influence management, since controlling shareholders, particularly those that are individuals, are not usually well-diversified and exit of a large stake is not an easy option without depressing share price.

A controlling shareholder structure could also present further benefits, since, with dispersed ownership, individual institutional shareholders could be overly focused on short-term financial metrics,[32] leading to company management, fearing that they can be removed as directors by the shareholders, prioritising short-term shareholder profits rather than investing in long-term projects

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[30] A detailed account of agency costs is beyond the scope of this study, but, succinctly, the principal managerial agency costs include (i) 'shirking' by focusing excessively on leisure time; (ii) overly committing time to other diversified business interests ahead of the business of the company; (iii) engaging in personal indulgences (such as 'pet projects' or 'empire building'); and, most egregiously (iv) diverting the cash flow or assets of the company for personal gain (often described as 'rent seeking').

[31] For example, M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J. Fin. Econ. 305, 308; and D. Fischel, 'The Corporate Governance Movement' (1982) 35 Vand. L. Rev. 1259, 1263.

[32] Even though the traditional 'efficient capital markets hypothesis' (with the relevant literature discussed in R. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Va. L. Rev. 549, 549) postulates that share price should reflect long-term performance, a body of study acknowledges that irrational short-term behaviours and informational asymmetries can be 'systematic' in nature leading to disproportionate short-term market bias (A, Shleifer, *Inefficient Markets: An Introduction to Behavioural Finance* (Oxford Univ. Press, 2000); R. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) Harvard Law School Discussion Paper No. 446 1, 14; and M. Moore and E. Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 J. Law & Soc. 416, 421).

that could be profitable in the long-term, but perhaps detrimental from a financial perspective in the short-term.[33] An obvious way in which the presence of a controlling shareholder could manifest itself in a long-term orientated board is through managerial stability.[34] Presuming that the relevant controlling shareholder itself bears a long-term outlook in relation to the prospects of the company, the management team will not be fearful of losing their employment if short-term metrics are not positive.[35] Although, it can not be assumed that a specific controlling shareholder has a long-term perspective, since the nature and identity of the controlling shareholder is critical,[36] to the extent that it does, the controlling shareholder structure will give the company the opportunity to follow such a strategy.

3. The Importance of Constraints

As outlined above, a controlling shareholder can moderate potential agency costs of management, on the one hand, but prejudice the interests of smaller shareholders on the other hand. A tradeoff exists[37] such that potential equity investors will have a preference for the presence of a controlling

[33] For an account of the manner in which management of a dispersed ownership company can react to short-term orientated shareholders with short-term orientated behaviour, see: Moore and Walker-Arnott (ibid 430 and 438), and M. Jensen, 'Agency Costs of Overvalued Equity' (Spring, 2005) Financial Management 5, 6.

[34] For instance, see: J. Ang and W. Megginson, 'Restricted Voting Shares, Ownership Structure, and the Market Value of Dual-Class Firms' (1989) 12 *The Journal of Financial Research* 301, 305.

[35] Controlling shareholder firms are also often associated with the development of strong and ingrained relationships with suppliers, customers, employees and other stakeholders (particularly true of family controlled companies – Cheffins (n 21) 38), which is conducive to long-term strategy. Additionally, such firms can limit the need to reduce managerial agency costs through implementing performance-related executive pay mechanisms which can exacerbate short-term behaviour by management (M. Maher and T. Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' in L. Renneboog, J. McCahery, P. Moerland and T. Raaijmakers (eds), *Convergence and Diversity of Corporate Governance Regimes and Capital Markets* (Oxford Univ. Press, 2000) 43 and 23; and Jensen (n 33) 14.

[36] Therefore, the propensity for controlling shareholders to take a long-term approach may be inflated (for example, Holderness and Sheehan (n 11) 338 found no statistical difference in controlling shareholder firms' long-term investment compared to dispersed ownership models).

[37] The term the 'controlling shareholder tradeoff' was first coined by Gilson and Gordon (n 12).

shareholder if the benefits from decreased managerial agency costs are greater than the detriments (if any)[38] from the extraction of private benefits by such controlling shareholder. If certain controls, limiting private benefit extraction, are in place, which are sufficiently 'weighty', the balance of the controlling shareholder tradeoff can be tipped in a direction that attracts minority investor investment in controlling shareholder structures. Such controls may be market-driven, psychological, or imposed through regulation.

A counter-argument to the importance of constraints is that if minority investors foresee future expropriation by a controlling shareholder, they can simply apply a discount to the price at which they are willing to acquire shares upon a listing[39] – a form of protection in so much that they would be purchasing the shares at a price that represents the potential expropriation by the controlling shareholder, and therefore earn a fair expected rate of return.[40] However, it is extremely difficult for investors to fully anticipate the level and nature of expropriation by a particular controlling shareholder,[41] and even if such expropriation were perfectly foreseen, such expropriation may not be fully embodied in equity price due to price reflecting the demand for shares by both minority and controlling shareholders,[42] or due to potential expropriation that takes time to crystalise not being factored-in due to short-term biases in the market.[43]

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[38] Private benefits could also be neutral or even positive for minority shareholders. For example, synergies between a controlling shareholder's separate businesses could be beneficial commercially to the relevant company, or the pursuit of greater prestige could have positive consequential effects on the success of the relevant company (M. Gutiérrez and M. Sáez, 'A Contractual Approach to Disciplining Self-Dealing by Controlling Shareholders' (2017) 2 *Journal of Law, Finance, and Accounting* 173, 197; and J. Dammann, 'Corporate Ostracism: Freezing Out Controlling Shareholders', (2008) 33 J. Corp. L. 681, 707).

[39] Gilson and Gordon (n 12) 5. Empirically, it has been shown that controlling block shares held by a controlling shareholder generally attract a premium, representing the private benefits of control (T. Nenova, 'The Value of Corporate Voting Rights and Control: A Cross-Country Analysis' (2003) 68 J. Fin. Econ. 325).

[40] Gutiérrez and Sáez (n 38) 179.

[41] See the discussion of the relevant empirical literature in Gutiérrez and Sáez (n 38) 180. Controlling shareholder actions may not be widely anticipated before they occur, nor widely known when they occur, meaning that they are not easily priced-in (Gilson and Kraakman (1984) (n 32) 592).

[42] M. Giannetti and Y. Koskinen, 'Investor Protection, Equity Returns, and Financial Globalization' (2010) 45 J. Financ. Quant. Anal. 135, 136 and 146.

Turning to Sports Direct, at the time of the IPO, the listing was not only heavily oversubscribed, but the share price was at the upper end of the company's valuation, suggesting that minority investors were not significantly discounting the shares of the company.[44] They viewed the benefits of the presence of Ashley as a controlling shareholder as outweighing the risks of expropriation. Subsequent to the IPO, the various working practices and corporate governance controversies have clearly contributed to a depression in the share price of the company,[45] signifying that the initial investors had not fully appreciated the downside risks. A number of other listed controlling shareholder companies have shown precipitous declines in share price after corporate governance failures, again showing that the potential for such failures had not been sufficiently priced-in at IPO.[46]

The importance of constraints can therefore be stressed from two related angles: compensating for risk not being priced-in correctly, and reducing the risk in the first place to eliminate the need for discounts. On the first aspect, if shareholders can not protect themselves *ex ante* by pricing-in risk appropriately, it is important to ensure that they are protected on an *ex post* basis by ensuring the constraints restraining controlling shareholders are robust. On the second aspect, to the extent that shareholders do discount controlling shareholder structures, such a discount represents an increase in the cost of public equity capital, and harms those controlling shareholder companies that are well-governed and not subject to a controlling shareholder inclined to engage in significant expropriation. Stronger constraints can reduce the level of discounts, and also potentially improve investor returns[47] and attract minority investors to the market.[48]

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[43] n 32 (particularly, Moore and Walker-Arnott (n 32) 420).

[44] See: Daily Telegraph article cited at n 8 above.

[45] From a review of Sports Direct historic market data as recorded and published by the *Financial Times* <https://markets.ft.com/data/equities/tearsheet/summary?s=SPD:LSE>, shares in Sports Direct were trading above 800p in August 2015, prior to news of the various scandals breaking, but had depressed to below 300p by the start of 2016.

[46] For example, ENRC (n 125 and 160), Bumi (n 145), Ferrexpo (n 153), and Essar Energy plc.

[47] See the discussion of the relevant empirical literature in Giannetti and Koskinen (n 42) 150.

[48] ibid 151 and 155.

A body of academic discourse has scrutinised the efficacy of market constraints[49] and, to a lesser extent, psychological constraints[50]. It is acknowledged that such 'organic' constraints could, in the first instance, even in the absence of regulatory constraints, protect minority shareholders. Although a detailed analysis is beyond the scope of this article, it is suffice to say that given the adverse press to which Sports Direct has been subject, and the ire of shareholders towards the controlling shareholder and the board,[51] such constraints were not, or are not, sufficient to adequately constrain a powerful, in terms of both voting power and personality, controlling shareholder. Therefore, the remainder of this article will focus on how, taking the example of Sports Direct and other pertinent controlling shareholder examples in the premium-listed company world, certain legal and regulatory constraints should be strengthened.

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[49] The capital markets have a significant constraining effect on the behaviour of controlling shareholders, since, with regular expropriation, the inclination for investors to become minority shareholders is significantly diminished, or the price at which they will invest will be substantially lower - as identified in a number of studies, including A. Shleifer and R. Vishny, 'A Survey of Corporate Governance' (1997) 52 J. Finance 737, 749; R. La Porta et al, 'Legal Determinants of External Finance' (1997) LII J. Finance 1131, 1149; Maher and Anderson (n 35) 18; and L. Bebchuk et al (n 27) at 305. Therefore, there is an incentive on controlling shareholders to treat minority shareholders fairly in order to, amongst other reasons, keep open the option to tap the capital markets for further finance in the future, and to maintain a market to partially or fully exit at an acceptable price.

[50] For example, A. Dyck and L. Zingales, 'Private Benefits of Control: An International Comparison' (2004) Vol. LIX J. Finance 537, 539. Reputation is often a meaningful psychological constraint (Flocos (n 9 above 1777); C. Holderness and D. Sheehan, 'Constraints on Large-Block Shareholders' in R. Morck (ed), *Concentrated Corporate Ownership* (Chicago: The University of Chicago Press 2000) 151; and R. Gilson, 'Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange' (2007) 60 Stan. L. Rev. 633, 643)).

[51] See, for example: (i) comments by Leon Kamhi, Hermes Investment Management <https://www.hermes-investment.com/blog/press/hermes-calls-substantive-changes-sports-direct/>; (ii) Legal & General Investment Management's position statement dated 25 August 2016 <http://www.legalandgeneral.com/advisercentre/campaigns/partnership-communications/pdfs/useful-documents/Sports_Direct_AGM_Position_statement.pdf>; (iii) AGM statement by Euan Stirling, Standard Life Investments, dated 7 September 2016 <http://pdf.standardlifeinvestments.com/CG_Statement_Sports_Direct_AGM/getLatest.pdf>; and (iv) press release by the Investor Forum dated 25 August 2016 < https://media.wix.com/ugd/1cf1e4_92f4632de08048fd8f551d92adc5158b.pdf>.

4. Legal and Regulatory Constraints

A plethora of laws and regulations exist in the UK evidently aimed at curtailing the powers of controlling shareholders, and, echoing the sentiment of Holderness and Sheehan above,[52] protecting 'small' shareholders. This article will examine in detail two specific areas of regulatory protection under the Listing Rules and their potential inadequacies:[53] firstly the regulations relating to the election of independent directors to the board; and, secondly, the regulations pertaining to related-party transactions.

A. *Selection of Independent Directors*

The UK Corporate Governance Code of the Financial Reporting Council (FRC) dated April 2016 (the Code) includes potential constraining mechanisms on controlling shareholders through minimum independent director provisions. Rather than providing for mandatory rules, premium-listed companies, such as Sports Direct,[54] are obliged, under the Listing Rules,[55] to either comply with the relevant provisions of the Code or explain reasons for deviations in the company's annual report. The Code urges that at least half the directors, not including the chairman, on the boards of FTSE-350 companies, including Sports Direct, are independent non-executive directors.[56] The Code also

[52] n 11 and accompanying text.

[53] The rules of the Listing Rules Sourcebook as published by the Financial Conduct Authority (FCA) in its capacity as the UK Listing Authority (the Listing Rules), which apply to companies listed on the Main Market of the LSE.

[54] A premium listing gives companies a greater level of prestige and enhanced reputation within the market on the basis that they are perceived to be held to higher corporate governance standards than those with a standard listing. A premium-listing is additionally significant since only shares with a premium-listing may be included on the FTSE indices, which is valuable, since certain investor funds will target such indices (for example, index tracker funds are required to invest in the companies comprising a relevant index, and fund managers subject to performance measurement against a particular index may seek to hedge risk by investing in such companies – see: B. Cheffins, 'The Undermining of UK Corporate Governance (?)' (2013) 33 Oxford J. Legal Stud. 503, 507).

[55] LR 9.8.6(5)R and LR 9.8.6(6)R.

[56] Code provision B.1.2.

specifies that in determining the independence of directors, a relevant consideration will be if such director is a representative of a significant shareholder.[57] Given that the Code also recommends that the chairman be independent upon appointment,[58] a controlling shareholder company in full compliance with the Code will, in theory, have implemented checks-and-balances to constrain the acts of a controlling shareholder through majority board voting being carried by directors independent from the controlling shareholder.[59]

Further emphasising the importance of independent directors in the face of a controlling shareholder, the Listing Rules were amended in May 2014, in response to a wave of controlling shareholder listings[60] and certain high profile abuses of power by controlling shareholders,[61] to provide that, where a premium-listed company has a controlling shareholder,[62] the election or re-election of independent directors must be separately approved by both the 'independent' shareholders (non-controlling shareholders) as well as the full body of shareholders.[63] If any such election or re-election is not approved pursuant to this dual voting mechanism, and the company desires to persevere with the relevant election, a further vote must be held at a meeting at least 90 days but not more than 120 days after the original vote,[64] and the relevant director, if already an existing appointee,

[57] Code provision B.1.1.

[58] Code provision A.3.1.

[59] Accordingly, independent director presence could moderate the prevalence of tunneling through related-party transactions (J. Dahya et al, 'Does Board Independence Matter in Companies with a Controlling Shareholder?' (2009) 21 J App Corp Fin 67, 76).

[60] Since the early 2000s, a number of foreign companies with significant blockholders have listed in London, especially from the mining and metals industries (Cheffins (n 54) 503).

[61] For example, in 2011, two independent directors were ousted from the board of the Kazakhstan company Eurasian Natural Resources Corporation (ENRC) by controlling blockholders acting in concert, after such directors criticised the corporate governance of the company and questioned the independence of the chairman. This led to one of the ousted directors describing the premium-listed company as 'more Soviet than City'.

[62] Subject to certain disregarded interests, a 'controlling shareholder' is any person who exercises or controls on their own, or together with any person with whom they are acting in concert, 30 per cent or more of the votes able to be cast on all or substantially all matters at general meetings of the company (LR 6.1.2AR).

[63] LR 9.2.2ER.

[64] LR 9.2.2FR.

may remain on the board during the interim period.[65] The resolution for such election will be passed at the subsequent meeting by a simple majority of votes exercised (including the votes of the controlling shareholder).

Although the dual vote requirement was a flagship reform under the 2014 amendments, doubts about its efficacy came to the fore at Sports Direct after the institutional shareholders became sceptical that the board embodied sufficient independence to effectively act as a check-and-balance on Ashley and his executive team.[66] In particular, the institutional shareholders were concerned that the chairman of the company was not providing sufficiently independent oversight. The requirement of a dual vote in relation to the appointment and re-election of independent directors should, in theory, give institutional shareholders the capacity to opine on the level of independence of those directors that the company has determined to be independent,[67] and, consequently, on 7 September 2016, as part one of the dual vote, the independent shareholders of Sports Direct voted against the re-election of the chairman of the company.[68] However, on 5 January 2017, as part two of the dual vote, at a shareholders' meeting where Ashley was entitled to exercise his votes, the chairman was re-elected; this was the case even though the percentage of independent shareholders exercising their votes at the second meeting against the re-election was similar to that at the first meeting.[69] If the purpose of the dual vote is to influence a controlling shareholder to either reconsider the re-election or appointment of the relevant director, or to restructure the board, for example by the addition of further independent

[65] LR 9.2.2DG.

[66] See: Publication by the Investment Association 'Adherence to the FRC's Stewardship Code at 30 September 2014 – Detailed practical examples' at 17-19. Also, on 30 June 2014, Roger Barker, director of corporate governance at the Institute of Directors said that there was, 'no effective check on Ashley's power' and that there was concern about 'weak underlying governance'.

[67] Particularly since Sports Direct has generally complied with Code provision B.7.1 that urges FTSE-350 companies to submit its directors to annual re-election.

[68] RNS Number: 2290J, 7 September 2016 - 55.82 per cent of the votes exercised at the meeting by independent shareholders were against the re-election of the Chairman as a director.

[69] RNS Number: 4625T, 5 January 2017 - including Ashley's shares, 80.92 per cent of the votes exercised at the meeting were in favour of the re-election of the Chairman as a director, but considering the independent shareholders solely, 53.96 per cent of votes exercised were against his re-election.

directors, prior to the second vote to assuage minority shareholder concerns, plainly that purpose was not fulfilled in the case of Sports Direct. Looking at recent controversies at Sports Direct, some, such as the accusation levelled against the company that workers were being paid below minimum wage and subject to harsh working conditions, could also easily have occurred at a dispersed ownership company with a significant independent non-executive director element. However, others, such as the company delaying the appointment of a permanent finance director, the recruitment of an individual with a personal connection to the controlling shareholder,[70] the investment in unrelated businesses,[71] the purchase of a corporate plane for £51.1m while earnings deteriorated,[72] and the entering into of transactions with a company owned by a family member of the controlling shareholder[73] may have been subject to more robust examination with a stronger independent element on the board. With each such controversy, the concerns of institutional shareholders have been aggravated.

The manner in which the dual vote procedure progressed at Sports Direct is not unique.[74] The nascent regulations requiring a dual vote were further stress-tested at the FTSE-250 company Ferrexpo plc (Ferrexpo). As with Sports Direct, Ferrexpo has a controlling shareholder with a greater than 50 per cent voting interest in the company.[75] On 19 May 2016, the re-elections of five directors that the board deemed to be independent were not approved by a majority of the independent

[70] In January 2016, Sports Direct entered into a consultancy agreement with the boyfriend of Ashley's daughter pursuant to which he would lead 'the Company's property team for the UK and internationally' (RNS Number: 6376K, 4 January 2016).

[71] n 22.

[72] As disclosed in Sports Direct's interim results for the 26 weeks to 23 October 2016 dated 8 December 2016, the company purchased a corporate plane for £51.1m while the group's underlying earnings (before interest, tax, depreciation and appreciation) had decreased by 33.5 per cent, and profits (before tax) had fallen by 57.0 per cent.

[73] n 16.

[74] However, during the short lifetime of the dual vote regulations, it has been rare for independent director re-appointments at FTSE-350 companies to be opposed by independent shareholders (for example, as set out in Glass Lewis' '2015 Proxy Season Highlights in the UK' (at 9 and 10).

[75] As set out in Ferrexpo's Annual Report and Accounts for the financial year ended 24 April 2017, Fevamotinico S.a.r.l. owned, as of 31 December 2016, 50.3% of the voting rights in the company (at 80), and, further underscoring the similarities to Sports Direct, the chief executive officer of Ferrexpo, Kostyantin Zhevago, is the indirect beneficiary of its controlling shareholder (at 50).

shareholders in the company.[76] The board swiftly announced its intention to hold a second vote to ensure that at least two of the five directors would be re-appointed; with respect to the other three directors, the board stated that a second vote on such directors would be held unless replacements could be found in the interim in line with the board's policy to replace each independent director after his or her ninth year of service. In fact, on 12 September 2016, all five directors were re-appointed pursuant to the second part of the dual vote where the controlling shareholder is permitted to exercise its votes.[77] Two of those five directors retired on 28 November 2016,[78] but nearly two years after the initial vote by the independent shareholders, three of the five directors still served as independent directors.[79] Again, the full will of the independent shareholders was not observed by the controlling shareholder, and to the extent it was partially observed, it was only after an extended period of time that would not have been palatable to the independent shareholders.[80]

The examples of Sports Direct and Ferrexpo illustrate that on the only occasions where the dual vote has come into play, it has not had the effect that the regulators intended in pressurising controlling shareholders to make substantive board room change. It is also instructive, as shown in Table A appended, that where there has been significant, albeit less than majority, independent shareholder opposition to the re-election of directors, the relevant companies often do not make consequential changes to the board. This suggests that companies and their controlling shareholders are not fearful of the consequences of potentially losing an independent shareholder vote on the re-election of such directors in the future, possibly as a result of the comfort blanket of the controlling shareholder being able to exercise its votes at the second stage. Given such obduracy of boards and

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[76] RNS number 7797Y, 19 May 2016.

[77] RNS number 6189J, 12 September 2016.

[78] RNS number 2165Q, 28 November 2016.

[79] Even though RNS number 1160I, 15 June 2017 announced the intention of the board to replace one such director, being the senior independent director, within a 'few months'.

[80] One of the main reasons for the independent shareholders' desire to remove such independent directors was that they were responsible for overseeing the deposit of US$174 million of the company's funds in a failing bank owned by the controlling shareholder (see: n 153 and accompanying text). An extended period of time after the independent shareholders had expressed their concerns during which such independent directors would still have had supervision responsibilities in relation to similar arrangements would have been an unsatisfactory state of affairs for the independent shareholders.

controlling shareholders to instigate change in such cases, it should not be unexpected that changes are also not being instigated sufficiently where an independent shareholder vote is both required by the regulations and lost.

Many of the revisions to the Listing Rules in 2014 were made partly in response to the corporate governance debacle at ENRC.[81] However, given the available evidence, it is difficult to argue that if the dual vote process had been in place while ENRC was a listed company, it would have constrained the controlling shareholders in any way – after all, the founders were certainly not shy in removing directors who were critical of the corporate governance standards at the company. At most, the regulations bestow independent shareholders with the ability to give a controlling shareholder a 'bloody nose', and, at worst, the regulations just introduce a second administrative step whereby the controlling shareholder merely rubber stamps its authority.[82]

B. *Related-Party Transactions*

Chapter 11 of the Listing Rules specifically applies to premium-listed companies and also protects minority shareholders through a requirement that transactions, above certain materiality thresholds,[83] between the company and, amongst others, a substantial shareholder[84] must at least be confirmed by

[81] n 61.

[82] The fund manager Fidelity International has also criticised the efficacy of the dual voting mechanism, with its head of corporate finance stating that in the specific case of the appointment or re-election of an independent chairman, the controlling shareholder should not be permitted to vote on any follow-on resolution after opposition by a majority of the independent shareholders on the initial vote. The media labelled this proposal the 'Anti-Ashley Clause' (see: David Campbell, 'Fidelity: directors should face boot over pay revolts' *CityWire Money* (17 February 2017) <http://m.citywire.co.uk/money/fidelity-directors-should-face-boot-over-pay-revolts/a993007?listref=latest-news>).

[83] Transactions in the ordinary course of business are excluded under LR 11.1.5R, as are transactions below the thresholds set out in LR 11 Annex 1.1R (n 85).

[84] Subject to certain disregarded interests, a 'substantial shareholder' is any person who is entitled to exercise, or to control the exercise of, 10 per cent or more of the votes able to be cast on all or substantially all matters at general meetings of the company (or of any company which is its subsidiary undertaking or parent undertaking or of a fellow subsidiary undertaking of its parent undertaking) (LR 11.1.4R).

the company's sponsor to be fair and reasonable to its shareholders and disclosed upon the entering into of the transaction, or, if large enough, be pre-approved by the other shareholders.[85] In certain circumstances,[86] the materiality thresholds are disapplied in the presence of a controlling shareholder,[87] further strengthening the effectiveness of the constraint.

Pursuant to the 2014 amendments, the FCA further enhanced the Listing Rules in order to '*ensure that the protections afforded to holders of equity shares by the premium listing requirements are meaningful*'.[88] Premium-listed companies had already been required to maintain independent businesses, but this was fleshed-out with the inclusion of situations where such independence may be compromised, such as where a controlling shareholder has undue influence over the business of the company. Additionally, controlling shareholder firms became required to effect 'relationship agreements' with the relevant controlling shareholder,[89] pursuant to which the controlling shareholder must agree that: any transactions with the controlling shareholder or any of its associates will be conducted at arm's length and on normal commercial terms; neither the controlling shareholder nor any of its associates will take any action that would have the effect of preventing the company from complying with its obligations under the Listing Rules; and neither the controlling shareholder nor

[85] Chapter 11 of the Listing Rules. If the transaction in question is of a size large enough such that, upon the application of certain 'class tests', the 'percentage ratio' of any such class test is above 5 per cent, independent shareholder approval of the transaction is required prior to the company entering into that transaction (LR 11.1.7). A detailed analysis of the class tests is beyond the scope of this article, but they broadly follow a classification of the size of a transaction against the size of the company in accordance with a gross assets test, a profits test, a consideration test and a gross capital test pursuant to LR 10 Annex 1. If all such class test percentage ratios are below 5 per cent, but one or more are above 0.25 per cent, independent shareholder approval is not required, but prior to entering into the transaction, the company must obtain confirmation from its sponsor that the transaction is fair and reasonable to its shareholders and the transaction must be publicly disclosed as soon as possible upon entering into the transaction (LR 11.1.10R). If all class test percentage ratios are below 0.25 per cent, the Listing Rule requirements in relation to related-party transactions do not apply (LR 11.1.6R and LR 11 Annex 1).

[86] For example, where the company has breached its obligation to put in place a 'relationship agreement' with a controlling shareholder (n 89 and accompanying text), or in the case where a relationship agreement has been implemented, the company is aware that the independence provisions therein have been breached (LR 11.1.1AR).

[87] For the definition of 'controlling shareholder', see: n 62.

[88] LR 6.5.2G.

[89] LR 6.1.4BR and LR 9.2.2R.

any of its associates will propose or procure the proposal of a shareholder resolution that circumvents the proper application of the Listing Rules.[90]

The importance of the Listing Rules in restricting potentially self-serving related-party transactions by controlling shareholders is highlighted by the lack of effectiveness in relying on potential breaches of directors' duties. It could be argued that the directors would be in breach of their duties to the company in effecting, or consenting to, a related-party transaction between the company and the controlling shareholder that was not in the interests of the company,[91] but it would be incumbent on the company itself, *prima facie* through its management organ, the board, to enforce those breaches against the directors. Naturally the zeal of a board to litigate against itself is slight, and therefore such a claim would be consigned to a minority shareholder or minority shareholders commencing a derivative claim on behalf of the company.[92] Although derivative claims have become more accessible from a procedural perspective since they took on a statutory footing, from a practical perspective, for a minority shareholder with only a small interest in the relevant company, the potential benefits of making a claim will likely be far outweighed by the efforts and costs involved (since any successful remedy will accrue to the company itself). Furthermore, it would be just as beneficial for that shareholder to 'free-ride' on the efforts of another shareholder, and, additionally, it may be easier for the shareholder to merely sell its shares and exit. It is, thus, improbable that the prospect of a derivative claim will weigh heavily on a decision of a board (particularly a controlling shareholder on the board) in considering a related-party transaction,[93] except in the most intemperate

[90] LR 6.1.4DR.

[91] For example, paraphrasing the Companies Act 2006, the duty to exercise independent judgment (s 173), the duty to promote the success of the company for the benefit of its members as a whole (s 172), the duty to act with skill, care and diligence (s 174), and the duty to avoid conflicts of interest (s 175).

[92] Pursuant to the Companies Act 2006, ss 260-264.

[93] Derivative claims are unlikely to form much of a deterrent to directors in this context – from a search on 14 March 2018 of the English case law database of Lexis Library using the terms 'derivative claim', 'plc' and 'Companies Act 2006', since derivative claims took on a statutory footing under the Companies Act 2006, there has only been one instance where a minority shareholder of a UK publicly listed company has applied for leave to commence a derivative claim, and in that case (*Bridge v Daley* [2015] EWHC 2121 (Ch)) leave was refused. Likewise, it is rare for non-executive directors of publicly

of instances. Potential sanction under the Listing Rules, on the other hand, serves as a more potent deterrent.[94]

On the face of it, the Listing Rules' related-party provisions should considerably restrict the capacity of a controlling shareholder to enter into large self-serving transactions with the company.[95] However, even though Ashley has entered into a written and legally binding relationship agreement with the company,[96] and Sports Direct has apparently complied with all related-party requirements, it appears that the current provisions have not prevented allegedly unpropitious behaviour by the controlling shareholder, nor been sufficient to pre-empt various controversies.

For example, although Sports Direct disclosed certain transactions with companies directly or indirectly wholly-owned by Ashley, such as Newcastle United Football Club and St James Holdings Limited,[97] and Double Take Limited (in which his daughter is a director),[98] certain other transactions that were not initially disclosed have attracted controversy. These include a consultancy agreement between Sports Direct and the boyfriend of Ashley's daughter,[99] and a services agreement between Sports Direct and a company owned and controlled by Ashley's brother.[100]

Under the International Accounting Standards (IAS),[101] related-party transactions must be specifically disclosed within the annual accounts.[102] The FRC has commenced an investigation into

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listed companies to suffer out-of-pocket liability (see: B. Black et al, 'Liability Risk for Outside Directors: a Cross-Border Analysis' (2005) 11 *European Financial Management* 153), diluting the deterrent effect further.

[94] Breaches of the Listing Rules can attract censure and fines enforced by the FCA, or in serious circumstances, a suspension or cancellation of the issuer's listing (ss. 91 and 77 of the Financial Services and Markets Act 2000).

[95] Limiting the ability of the controlling shareholder to engage in 'tunneling' (n 13 and accompanying text).

[96] Sports Direct's 2016 Accounts at 44.

[97] Sports Direct's 2016 Accounts at 104.

[98] As disclosed in Sports Direct's interim results for the 26 weeks to 23 October 2016 dated 8 December 2016 at 4.

[99] n 70.

[100] n 16.

[101] Pursuant to Article 4 of EC Regulation No. 1606/2002, companies with their securities listed on a regulated market in a European Member State must prepare their consolidated accounts in conformity with the International Accounting Standards. This requirement is reiterated in the Companies Act 2006, s 403.

[102] IAS 24.

Sports Direct's auditors with respect to the absence of a disclosure in relation to the transaction with the company owned by Ashley's brother in the Annual Accounts of the company for the year ended 24 April 2016,[103] on the basis that a sibling would be considered to be 'a close member of a controlling shareholder's family' under IAS 24. With respect to the transaction with the boyfriend of Ashley's daughter, it is likely that a cautious auditor would also deem that to be a transaction with a close member of Ashley's family, although the point is not free from doubt.[104]

Beyond disclosure in the annual accounts required in accordance with IAS, as above, pursuant to the Listing Rules, certain related-party transactions must at least be confirmed by the company's sponsor to be fair and reasonable to its shareholders and disclosed by the company upon completion, and, subject to size, pre-approved by the independent shareholders;[105] however, there are two crucial qualifications: (i) generally, the relevant provisions only apply to related-party transactions that exceed requisite thresholds[106], with the caveat that, in the case of a controlling shareholder company, if the relationship agreement with a controlling shareholder has been breached, the thresholds fall away;[107] and (ii) curiously, the definition of 'related-party' under the Listing Rules is, in many respects, narrower than that under IAS 24. Therefore, even if such controversial transactions had exceeded the materiality thresholds under the Listing Rules, the company may have been able to justify not initially divulging those transactions and, even if those transactions were particularly large, not seeking independent shareholder approval, on the basis that the counter-parties were not strictly within the definition of 'related-party' under the Listing Rules.[108] Transactions with

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[103] Announcement PN68/18 of the FRC dated 28 November 2016.

[104] In effect, transactions with close members of the controlling shareholder's family should be disclosed under IAS 24; 'close members of the family' is defined as 'those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity' (IAS 24, paragraph 9).

[105] n 85 and accompanying text.

[106] n 83 and 85.

[107] Listing Rules 11.1.1AR and 11.1.1CR.

[108] Under Listing Rule 11.1.4R, a 'related-party' is defined to be (i) a person who is (or was within the 12 months before the date of the transaction or arrangement) a substantial shareholder; (ii) a person who is (or was within the 12 months before the date of the transaction or arrangement) a director or shadow director of the listed company or of any other company which is (and, if he has ceased to be such, was while he was a director or shadow director of such other company) its

associates of a substantial shareholder,[109] like Ashley, or companies in which they have substantive direct or indirect interests are caught by the regulations, as are transactions with companies whose directors are accustomed to act in accordance with the substantial shareholder's instruction. However, the definition of associate, in the context of an individual's family, only includes that individual's spouse, civil partner or child. Taking Sports Direct as a real-world example, it seems akin to a lacuna that an individual's sibling or child's civil partner are not caught by the regulations. It should be noted that there are no suggestions or evidence that either of the non-disclosed transactions are suspicious in any way, but the relevant controversy and bad publicity due to the perceived clandestine nature of the transactions could have been tempered if the transactions had at least been disclosed as related-party transactions and confirmed by the company's sponsor as fair and reasonable under the Listing Rules.

Even if the counterparties under the relevant controversial transactions had satisfied the definition of 'related-party', it is doubtful that the controversy would have been doused, since it is likely that the relevant transactions would not have exceeded the materiality thresholds under chapter 11 of the Listing Rules.[110] As mentioned above, the materiality thresholds are dispensed with if a relationship agreement between the controlling shareholder and the company has been breached. Significant in this regard is that such a relationship agreement must include a term pursuant to which the controlling shareholder agrees that any transactions between that controlling shareholder and / or such controlling shareholder's associates will be conducted at arm's length and on normal commercial terms.[111] Therefore, if any related-party transaction with Sports Direct had not been on arm's length and on normal commercial terms, it would have had to have been disclosed and approved by the independent shareholders. On first blush, this would appear to be sufficient to protect the interests of the independent, minority shareholders. However, it has been posited that 'arm's length terms' essentially necessitates that the relevant transaction has been conducted at market value, and that the

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subsidiary undertaking or parent undertaking or a fellow subsidiary undertaking of its parent undertaking; (iii) a person exercising significant influence; or (iv) an associate of a related-party referred to in paragraph (i), (ii) or (iii).

[109] For the definition of 'substantial shareholder', see: n 84.

[110] n 85.

[111] LR 6.1.4DR. Also see: n 90 and accompanying text.

determination of market value is not an exact science.[112] 'Market value' could be deemed to be a value within a broad range.[113] Furthermore, the subjective intentions of the directors at the time the relevant decision was made could also be germane;[114] ascertaining such subjective intention is a notoriously difficult task. Therefore, so long as the transaction has been negotiated by the relevant parties on an independent basis without any element of duress from either side, on terms that could be obtained in a commercial transaction between two unrelated parties, such transaction would likely be considered to be on an arm's length basis and on normal commercial terms. Following on from this reasoning, a transaction with a related-party may well be on an arm's length basis and on normal commercial terms, but not necessarily better than the deal that the company could have achieved by transacting with another third party – a transaction could be on arm's length terms but not necessarily the best deal that could have been obtained through a competitive tender process. Such a transaction could stand even though, with the benefit of hindsight, it is found to be a bad bargain.[115] The potential for a relevant transaction to be effected with a related-party without a competitive tender open to third parties is high in the presence of a controlling shareholder, and given the broad appraisal of 'arm's length terms' the company, and by extrapolation the minority shareholders, may not be getting the best deal.[116]

[112] E. Micheler, 'Disguised Returns of Capital – An Arm's Length Approach' (2010) 69 Camb. L. J. 151, 185.

[113] ibid 185. Also, in the context of determining whether a transaction at an undervalue is a disguised return of capital, in *Clydebank Football Club Ltd v Steedman* (2002) SLT 109, (2000) GWD 31-1217 [76] (Hamilton L), it was stated: 'In assessing the adequacy of the consideration, a margin of appreciation may properly be allowed'.

[114] *Progress Property Company Limited v Moorgarth Group Limited* [2010] UKSC 55, [2011] 1 WLR 1 [29].

[115] ibid at [29].

[116] In the context of determining whether a transaction at an undervalue is a disguised return of capital, Lord Hamilton (n 113) at [76] stated that: 'If the transaction is genuinely conceived of and effected as an exchange for value and the difference ultimately found does not reflect a payment "manifestly beyond any possible justifiable reward for that in respect of which allegedly it is paid", does not give rise to an exchange "at a gross undervalue" and is not otherwise unreasonably large, there will not to any extent be a "dressed up return of capital"'.

5. Proposals for Regulatory Reform

Following on from the identification of inadequacies in the current regulations in the context of the election of independent directors and related-party transactions, this paper continues with proposals for regulatory reform.

A. *Selection of Independent Directors*

With regard to the independence requirements under the Code, the 2016 Annual Report of Sports Direct stated[117] that the company had complied with the relevant requirements on the basis that four out of seven of the directors on the board were non-executives, all of whom the company considered to be independent.[118] However, as above, the institutional shareholders still voted against the re-election of the chairman in spite of the company's declaration of independence. Additionally, notwithstanding that the Code specifies that independence may be prejudiced if a non-executive director has served on the board for more than nine years from the date of his or her first election,[119] the company maintained that all non-executives were independent even though the senior independent director had served on the board for more than nine years, and an additional non-executive had served on the board for almost eight-and-a-half years. Given the company's affirmation of compliance with the Code with respect to independence, one formerly advocated solution - to mandate the independence composition of boards in the presence of a controlling shareholder[120] - would be

[117] Sports Direct's 2016 Accounts at 47.

[118] Sports Direct's 2016 Accounts at 49.

[119] Code provision B.1.1. The FRC is consulting on strengthening this provision to include that such directors should not be considered independent rather than merely stating that such a quality is relevant in determining independence (FRC Consultation - Consulting on a revised UK Corporate Governance Code, December 2017).

[120] In October 2012, the Financial Services Authority published its Consultation Paper on 'Enhancing the effectiveness of the Listing Regime and feedback on CP12/2' (CP12/25), making a proposal that where a controlling shareholder exists in a premium-listed company, such company must, on a mandatory basis, ensure that a majority of independent directors serve on the board (at 14). The proposal was not subsequently implemented.

unlikely, in and of itself, to have a substantive effect on controlling shareholder behaviour in the UK so long as the determination of independence is in the hands of the board. Even if regulation expressly provided that directors would not be considered to be independent if they had specific existing relationships with the company or controlling shareholder (akin to the factors that a board must take into account in determining independence under Code provision B.1.1), it would still be difficult to ascertain whether, in fact, notwithstanding avoidance of those relationships, the relevant director was independent in practice.[121] It is doubtful that mandatory regulation would satisfy the lack of confidence that institutional shareholders of a controlling shareholder company would have in the ability of those non-executive directors to exercise independent judgment in practice;[122] the suspicion would always remain that those directors have been directly or indirectly cherry-picked by the controlling shareholder.

However, the concerns of institutional shareholders could be assuaged through amending the current dual vote requirements. In the presence of a shareholder, or connected shareholders, owning greater than 50 per cent of the voting rights in a listed company, shareholders independent of such controller should be given the unfettered right to approve the appointment or re-election of any director that the board has nominated as an independent non-executive director – in effect, both the independent shareholders and the whole shareholder body exercising votes at the meeting must approve such appointment at the same meeting, and in the event that the independent shareholders do not pass the resolution, the appointment or re-election would be deemed definitively refused and not subject to a second resolution where the appointment may be ratified if sanctioned by the entire shareholder cohort (including the controlling shareholder) exercising votes at that second meeting as is currently the case.

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[121] It would therefore appear that market forces or market constraints are sufficient drivers to ensure that Sports Direct is in full compliance with the independence provisions under the Code. However, whether such independent directors are truly independent in practice is another matter entirely. The potential for such 'tick-the-box' compliance with the Code where compliance is not necessarily equated with adherence to the spirit or principles of the Code is a common criticism of the 'comply-or-explain' approach (for example, see: S. Arcot and V. Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK' (2006) London School of Economics Working Paper 1; and M. Moore, '"Whispering Sweet Nothings": The limitations of informal conformance in UK corporate governance' (2009) 9 JCLS 95, 118.

[122] Daniels and Halpern (n 28) 59 and 60.

The fundamental issue of whether independent non-executive directors are effective in monitoring controlling shareholders should also be visited. Even with a substantive presence of outside directors, their efficacy in monitoring controlling shareholders is questionable. In the UK, currently, pursuant to section 168 of the Companies Act 2006, a controlling shareholder with the right to exercise greater than 50 per cent of the votes in a company can remove any director at will. It is therefore conceivable, given the prestige attached to the role of being a non-executive director on a premium-listed company board, that an 'independent' non-executive director may be hesitant to be an overly fierce watchdog with respect to a controlling shareholder who could remove such director from the board.[123] By reforming the dual voting mechanism, as suggested above, so that independent director appointments and re-elections require the definitive approval of the minority independent shareholders, the independent directors would be beholden to two masters – the controlling shareholder and the minority independent shareholders – thereby diminishing the incentive for obsequious behaviour towards the controlling shareholder. Of course, there is always the possibility that if an independent director is too good, so to speak, at his or her job in monitoring a controlling shareholder, the controlling shareholder could still remove such independent director,[124] but at least any replacement, designated by the board to be independent, will need to be sanctioned by the independent shareholders, and, in any case, the controlling shareholder may be dissuaded from acting to dismiss directors in such a manner for fear of adverse market consequences.[125]

It is critical, though, that any such enhancement of the dual voting requirement should only apply where the relevant controlling shareholder can exercise greater than 50 per cent of the voting

[123] J. Seligman, 'Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy' (1985-1986) 54 Geo. Wash. L. Rev. 687, 722; Daniels and Halpern (n 28) 16; P. Halpern, 'Systemic Perspectives on Corporate Governance Systems' in S. Cohen and G. Boyd (eds) *Corporate Governance and Globalization: Long Range Planning Issues* (Northampton: Edward Elgar Publishing Inc. 2000) 29; N. Kumar and J. Singh, 'Outside Directors, Corporate Governance and Firm Performance: Empirical Evidence from India' (2012) 4 *Asian Journal of Finance and Accounting* 39, 44; and L. Bebchuk and A. Hamdani (n 128) 18.

[124] For a real world example of this, see: n 61.

[125] The experience of ENRC is pertinent. The company's corporate governance furore (n 61) resulted in a slide in share price (see: Helen Thomas, 'ENRC bolsters board to improve corporate governance' *Financial Times* (25 May 2012) <https://www.ft.com/content/393db758-a67c-11e1-968b-00144feabdc0>).

rights – the current dual voting requirements apply to any controlling shareholder able to exercise 30 per cent or more of the voting rights.[126] For a controlling shareholder that does not, while acting alone, have the power to remove directors from the board, it would be iniquitous to create a situation where potentially the other, minority, shareholders acting in cahoots with the board, could have control over the appointment of certain board members to the exclusion of the non-majority controlling shareholder (who can not subsequently remove such board members if dissatisfied). It is not the intent that the proposed reform should completely dis-enfranchise a controlling shareholder in this regard.[127]

In the US (Delaware) context, Bebchuk and Hamdani[128] go even further by espousing that minority shareholders should, in the presence of a controlling shareholder, have enriched rights with respect to specifically designated 'enhanced independence directors' – such minority shareholders would similarly have veto rights with respect to the initial appointment of such directors, but even stronger rights with respect to re-election, whereby the minority shareholders would be able to re-elect such 'enhanced independence directors' in spite of any desire of the controlling shareholder to terminate the relevant appointment. However, it is submitted that, in a UK context, this would overly dis-enfranchise the controlling shareholder. Moreover, the proposals outlined herein are not intended to enable minority shareholders to endorse the election of independent directors to the objection of the majority shareholder. Independent directors would need to be approved by both the independent shareholders acting as a group and by the entire body of shareholders including the controlling shareholder. In that way, the unpalatable situation of a board composed of directors appointed purely by differing factions, and the attendant risks to trust and smooth information flow between directors, would not occur. It is acknowledged that a deadlock scenario could occur where the minority shareholders and controlling shareholder do not agree upon a candidate. In such a case, the company

[126] n 62.

[127] As long as the proposed reform only applies to true controlling shareholders holding more than 50 per cent of the votes, the controlling shareholder would always have a veto right over the appointment of any independent director (and, in practice, would likely have significant influence over the nomination of any such director), and complete control over the appointment of executive directors and non-executive directors that are deemed to not be independent.

[128] L. Bebchuk and A. Hamdani, 'Independent Directors and Controlling Shareholders' (2017) 165/6 U. Pa. L. Rev. 1271, 1301.

would continue without complying with the independence requirements under the Code, and therefore having to suffer the potentially adverse market consequences from the perception that the board does not comprise sufficient independence. In practice, though, the reform proposal would lead to greater communication between the controlling shareholder and independent shareholders before the relevant vote in an attempt to form a consensus, in much the same way that the implementation of binding 'say-on-pay' votes has appeared to create greater *ex ante* engagement between companies and shareholders.[129] This author also welcomes the recent proposals to require premium-listed companies subject to significant voting opposition to engage meaningfully with shareholders.[130] If the definition of 'significant opposition' were to also apply to significant opposition by independent shareholders in the context of the dual vote, it is unlikely that such a deadlock would persist for a long period of time, especially given the importance that premium-listed companies attach to complying with the Code's board independence requirements.[131]

B. *Related-Party Transactions*

Taking into account the controversial transactions of Sports Direct outlined above, at the very minimum, there is a strong case to extend the definition of 'related-party' to the more extensive definition of 'associate' pursuant to the Financial Conduct Authority's Consumer Credit Sourcebook. The definition used therein[132] covers a spouse or civil partner of the relevant person, and any relative of the relevant person, as well as a spouse or civil partner of such relative. 'Relative' would clearly encompass a brother and a daughter, and therefore, with such an extended definition, the transactions of Sports Direct with Ashley's brother, and with the civil partner of his daughter, if they had exceeded

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[129] R. Thomas and C. Van der Elst, 'Say on Pay Around the World' (2015) 92 Wash. U. L. Rev. 653, 730; and the August 2017 CIPD Research Report 'Executive Pay - Review of FTSE 100 executive pay packages' at 2.

[130] FRC Consultation (n 119) at 9.

[131] Pursuant to Grant Thornton's 2017 Corporate Governance Review (at 28), only around 8% of the report's sample of FTSE-350 companies did not comply with the independence requirements under B.1.2 of the Code. Also, see: n 121.

[132] The definition tracks the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended by the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2013), s 60(L).

the relevant materiality thresholds, would have been 'related-party transactions' requiring disclosure, sponsor confirmation of fairness, and, if sizeable, shareholder pre-approval under the Listing Rules, rather than independent shareholders having to wait for disclosure *ex post* in the annual accounts pursuant to IAS 24.

As mentioned, even with an extended definition of 'related-party', if such transactions were below the relevant thresholds,[133] they would still not require a fairness opinion from the company's sponsor and disclosure as soon as possible after completion. It has further already been expressed in this article that the disapplication of the thresholds upon relationship agreement breach does not adequately protect minority shareholders given the vagueries of the concept of 'arm's-length terms'. It is therefore hereby advocated that, with an incumbent controlling shareholder, it would be judicious to ensure that all transactions, no matter size, with the controlling shareholder and its associates are, at the very least, disclosed at the time of the transaction and confirmed by the company's sponsor to be fair and reasonable to the shareholders, to eliminate any perception of nefarious conduct and encouraging the controlling shareholder to justify the business benefit for the company in each case.[134]

A revision to the regulations on related-party transactions in the presence of a controlling shareholder can be further justified by exploring the only two instances, as of the date of this article, where the FSA[135] or FCA has sanctioned companies for breaches of such provisions. Unsurprisingly, both instances involved companies with controlling shareholders. In 2015, the FCA issued a final notice in relation to breaches of, amongst other things, the related-party provisions of the Listing

[133] n 85.

[134] Although, such prudence is only necessary in the presence of a 'controlling shareholder' (defined as set out in n 62) as opposed to a mere 'substantial shareholder' (defined as set out in n 84), since the influence of a substantial, non-controlling shareholder to cause the company to enter into such potentially 'bad' bargains with related parties will be necessarily reduced as compared to that of a controlling shareholder. Therefore, with respect to mere 'substantial shareholders' the regulations as they currently stand are adequate.

[135] The FSA, being the Financial Services Authority, had responsibility for the regulation of the financial services industry until it was abolished on 1 April 2013, at which time its responsibilities vis-à-vis the Listing Rules were assumed by the FCA.

Rules by Asia Resource Minerals plc.[136] The company, formerly known as Bumi plc, along with ENRC,[137] is often held out as the poster child for controlling shareholder abuses. The company was found to have breached the relevant regulations with respect to three admitted related-party transactions. Two of those transactions individually exceeded the thresholds that required the company to obtain sponsor confirmation as to the fairness and reasonableness of the terms and to disclose such transactions upon entering into them, pursuant to chapter 11 of the Listing Rules,[138] while the third transaction was subject to the same rules as a result of the requirement to aggregate the value of all transactions with the same related-party within a period of twelve months.[139] It appears that the company did not implement adequate internal procedures to identify the relevant related-party transactions,[140] which were only discovered after the company's financial advisor was requested to investigate various financial irregularities within the company. In this case there was significant uncertainty as to whether the transactions exceeded the relevant related-party transaction materiality thresholds,[141] and, as such, the company should have obtained sponsor guidance.[142] Of further particular note, in the context of the reforms proposed by this article, are a number of 'other transactions' amounting to US$225.3 million identified by the financial advisors as having no clear business purpose or where the ultimate beneficiary was unclear. The company stated that it considered certain of these transactions were in the ordinary course of business[143] and no further related-party analysis was required on that basis.[144] Subsequent to the internal investigation, those 'other transactions' became the subject of a controversial and long-running legal dispute between the company and Rosan Roeslani, a non-executive director of the company, and the president of one of

[136] The FCA's Final Notice to Asia Resource Minerals plc dated 12 June 2015 (the Asia Resource Final Notice).

[137] See: n 61, and n 158 and accompanying text.

[138] n 85.

[139] Pursuant to LR 11.1.11R. See: paragraphs 5.13 to 5.15 of the Asia Resource Final Notice.

[140] The relevant admitted related-party transactions took place between 28 June 2011, the date of the company's listing, and 19 July 2013.

[141] n 83 and 85.

[142] Paragraph 2.10 of the Asia Resource Final Notice.

[143] See; paragraph 4.42 of the Asia Resources Final Notice.

[144] n 83.

the company's subsidiaries.[145] Significantly, Roeslani was a substantial shareholder in the company and also had close connections with the major shareholder of the company, the Bakrie family.[146] If the carve-out for 'ordinary course of business' transactions and the materiality thresholds were not available in the presence of a controlling shareholder, in relation to the admitted related-party transactions, the company would not have been subject to any level of uncertainty and would have identified those transactions as related-party transactions immediately. Furthermore, in relation to the transactions that became the subject of alleged wrong-doing, they would surely have been highlighted as related-party transactions, and therefore subject to greater scrutiny by both the company and its shareholders, requiring *ex ante* sponsor confirmation as to the fairness and reasonableness of their terms and immediate disclosure. The FCA, in criticising the internal procedures of the company, noted the increased risks inherent in its group structure and subsidiary director relationships, as well as potential conflicts between the company's founding shareholders, operations and subsidiaries.[147]

Exillon Energy plc is another controlling shareholder firm that was the subject of a FSA Final Notice[148] for breaches of the related-party transaction provisions of the Listing Rules. The transactions in question involved payments for expenses to the chairman who was also indirectly the beneficial owner of the controlling shareholder.[149] The persons internally responsible for approving such transactions did not identify them as related-party transactions since they viewed such payments as being in the recipient's capacity as an employee, notwithstanding that he was also a director and controlling shareholder.[150] The fact that each individual payment was minimal will have also had a bearing on them being missed by the responsible persons, since larger payments would surely have set alarm bells ringing. Accordingly, the company failed to aggregate the relevant transactions in

[145] News of the internal investigation into financial irregularities in the company resulted in a drastic fall in share price (see: Helen Thomas, 'Bumi looks into alleged irregularities' *Financial Times* (28 September 2012) <https://www.ft.com/content/74b8874c-08ae-11e2-b57f-00144feabdc0?mhq5j=e1>).

[146] See: Panel Statement 2012/9 of the UK's Panel on Takeovers and Mergers.

[147] See: paragraphs 2.7 and 5.5 of the Asia Resources Final Notice.

[148] FSA Final Notice to Exillon Energy plc dated 26 April 2012 (the Exillon Final Notice).

[149] Annual Report and Accounts of Exillon Energy plc for the financial year ended 31 December 2009 at 23.

[150] See: paragraph 19 of the Exillon Final Notice. Directors and controlling shareholders are clearly related parties under the Listing Rules (LR 11.1.4R (1) and (2)).

determining whether the threshold for notification had been surpassed.[151] Although it can not be said for certain that the breach would still not have occurred if the thresholds were eliminated in the presence of a controlling shareholder, the evaluation process would have been far simpler and the minds of those responsible would certainly have been more sharply focused.

There are plentiful other examples of controlling shareholder controversies that would not have been so contentious if the relevant transactions had been required be confirmed as fair and reasonable, and immediately disclosed, to minority shareholders. For example, the circumstances prompting the independent shareholders of Ferrexpo to vote against the re-election of certain independent directors[152] involved the insolvency of a Ukrainian bank in which the company had deposited US$174 million of its total cash balance of US$280 million.[153] The bank was controlled by the controlling shareholder of Ferrexpo. Even though the deposit of funds in a bank account would very much fall within the ambit of the 'ordinary course of business' exception under the related-party transaction regulations,[154] it would obviously have been provident for the arrangement as a whole to have been disclosed to the shareholders and subject to a fair and reasonable qualification by the company's sponsor given the large funds involved.[155] This is particularly felicitous given that the company's allocation of the liquidation proceeds may be hampered by the related-party nature between the company and the bank.[156] ENRC, a company which is no stranger to controlling

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[151] See: n 139 and accompanying text.

[152] n 75 to n 80 and accompanying text.

[153] The bank was declared insolvent on 17 September 2015 (RNS number 4726Z, 18 September 2015).

[154] It would also have been unlikely that the deposit of funds in a bank account would have been on anything other than on arm's length terms; hence it would not have constituted a breach of the relationship agreement between the company and its controlling shareholder, and the relevant materiality thresholds (including the 'ordinary course of business' exemption) would not have been triggered.

[155] Upon the bank being declared insolvent, the price of shares in Ferrexpo dramatically fell by around a third (James Wilson and Roman Olearchyk, 'Shares in Ferrexpo hit by bank closure' *Financial Times* (18 September 2015) <https://www.ft.com/content/9431c744-5dd5-11e5-9846-de406ccb37f2?mhq5j=e1>.

[156] The liquidator in the insolvency proceedings classed the subsidiaries of Ferrexpo which had deposited funds in the insolvent bank as ninth in creditor priority in the liquidation on the basis of such subsidiaries being 'related parties' to the bank (note 35 to the financial statements as set out in the Annual Report of Ferrexpo for the year ended 31 December 2016 at 143).

shareholder abuses,[157] also courted controversy when it was discovered that it had sold a subsidiary to the nephew of one of its controlling founders.[158] As outlined above, a nephew of a controlling shareholder would not be deemed to be a related-party pursuant to the Listing Rules, but would likely be considered to be a related-party for the purposes of IAS. Additionally, the company suggested that the transaction did not need to be disclosed since it did not meet the materiality thresholds requiring disclosure.[159] Therefore, an expansion of the definition of related-party to include 'relatives' of the controlling shareholder as promoted above, together with a relaxation of the materiality thresholds in the presence of a controlling shareholder, would have brought this transaction within the ambit of the related-party provisions of the Listing Rules requiring confirmation of fairness and prompt disclosure. This would have prevented the episode adding to the litany of negative publicity that besieged ENRC and depressed its share price during its time as a listed company.[160]

Although regulations will always need to tread a fine line between protecting against all eventualities and impinging detrimentally on the ability of a company to conduct business smoothly and efficiently, given the risks that are inherent in controlling shareholder structures, it would be prudent, in such situations, that all related-party transactions are at least subject to sponsor confirmation of fairness and reasonableness and disclosed to the shareholders as soon as possible after the transaction is effected, rather than merely disclosed much later pursuant to IAS. It would not be an overly onerous process for firms to implement, and, in relation to transactions conducted with specific counterparties on a regular basis, a streamlined process could be formulated with the company's sponsor.

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157 n 61.

158 Simon Goodley, 'ENRC subsidiary sold secretly to nephew of co-founder' *Guardian* (14 February 2013) <https://www.theguardian.com/business/2013/feb/14/enrc-mining-company-subsidiary-sold-secretly>.

159 ibid.

160 ENRC was de-listed from the Main Market of the LSE in November 2013, after the founders re-acquired the company. At the time of the company's listing, shares were listed at 540p, but share price had fallen to 217.25p by the time it was taken private. ENRC produced a total shareholder return of *minus* 54 per cent since its 2007 listing (James Wilson, Jonathan Guthrie and David Oakley, 'ENRC "should have set off alarm bells"' *Financial Times* (22 November 2013) <https://www.ft.com/content/1995e548-5368-11e3-b425-00144feabdc0?mhq5j=e1>).

The thresholds could be retained for the purposes of determining whether pre-approval by independent shareholders is required. One may ask why the reforms proposed by this article, requiring that all related-party transactions in the presence of a controlling shareholder be subject to a sponsor fairness confirmation and prompt disclosure, should not go further and recommend that all such transaction should be pre-approved by minority shareholders. It is acknowledged that there is merit in the argument, with the example of Ferrexpo being apposite in this regard – the potential loss to the company upon the insolvency of the bank is considerable, yet it is unlikely that individual bank deposits would have been deemed to be individual 'transactions' or 'arrangements' for the purposes of the Listing Rules; and, therefore, the general deposit arrangement with the bank would have been unlikely to have exceeded any particular materiality thresholds. However, given the vast risks to the company in depositing large sums with a single Ukrainian bank,[161] it would have been beneficial to the independent shareholders to have had the opportunity to pre-approve the arrangement in the first instance which would likely to have required the company to outline exactly how much it was intending to deposit with such bank going forward. The independent shareholders may well have pressed the company to diversify its Ukrainian accounts beyond the single bank owned by the controlling shareholder. It is essential, though, that regulatory reform does not have a chilling effect on controlling shareholders listing their firms in the UK given that controlling shareholders can also, when restrained by appropriate constraints, provide valuable benefits to firms. Requiring that all related-party transactions, notwithstanding size, should be pre-approved by independent shareholders would be a controversial development, and would need to be implemented carefully so as not to impinge upon the ability of the firm to conduct its business efficiently. Therefore, it is not hereby advocated that mandatory pre-approvals should be implemented, and instead mandatory sponsor fairness confirmation and prompt disclosure, as already extolled, should be applied as a first measure. The pre-approval of all related-party transactions in the presence of a controlling shareholder could,

[161] In fact, the company highlighted the weakness and undercapitalisation of the Ukrainian banking sector as a risk factor for the company's business in its Annual Report for the year ended 31 December 2014 (at 27); this casts further doubt on the rationality of holding the majority of the company's cash balance in a single account.

though, form an area ripe for further study[162] if the more moderate proposals outlined herein are found to be lacking when put into practice.

6. Conclusions

This paper has outlined the problematic theoretical consequences of the presence of a controlling shareholder in a listed company vis-à-vis the interests of the minority shareholders. Such theoretical consequences are also grounded in real world issues for listed companies as observed at the UK premium-listed company Sports Direct International plc. However, controlling shareholder structures do not solely present a myriad of detrimental outcomes for minority investors, and, as encapsulated by this paper, they can also present various benefits to a company with a corresponding increase in firm value profiting minority and controlling shareholders alike. In the context of Sports Direct, the controlling shareholder's experience and expertise in the business sector, as well as his incentive to ensure the long-term success of the company by virtue of his large shareholding in the company, are factors promoting the benefit of a controlling shareholder. For all the controversies surrounding Sports Direct, shareholders recognise the importance of the controlling shareholder to the business.[163] The reforms proposed by this article are therefore intentionally limited to ensure that they bolster the protections available to minority shareholders without being so onerous to substantially discourage controlling shareholders from listing on the LSE. It would not be constructive to the success of the

[162] For example, pre-approval of all related-party transactions could be implemented on a best practice basis through the Code rather than on a mandatory basis, or could be subject to certain enabling provisions, such as relaxed rules for specific types of controlling shareholders, blanket approvals for transactions with specific counterparties within certain limits, or deemed approval of transactions pre-disclosed in the listing prospectus or offer document, at the time of listing or upon the takeover of the company by the controlling shareholder, respectively.

[163] For example, Crispin Odey, the founder of Odey Asset Management LLP, a large minority shareholder in Sports Direct, was quoted: 'I'm very happy with him [Ashley]: he's a natural winner. From our point of view we always like to find entrepreneurs to back and I am very happy to be buying anything on eight times' earnings, especially when they have a proven track record like Sports Direct.' (see: Deirdre Hipwell and Harry Wilson, 'Mike Ashley? He's a natural winner, says Sports Direct backer' *Times* (7 January 2017) <https://www.thetimes.co.uk/article/mike-ashley-hes-a-natural-winner-says-sports-direct-backer-txt3n6z7t>).

UK economy for net positive controlling shareholder firms to choose other jurisdictions over the UK for initial public offerings of their equity interests.

The key is ensuring that the 'controlling shareholder tradeoff' is titled in such a direction to ensure that the benefits of a controlling shareholder outweigh the potential detriments. If constraints subsist that effectively limit the ability of a controlling shareholder to extract private benefits of control to the detriment of minority shareholders, the tradeoff can be shifted to an advantageous position for minority investors. In the UK, there are various constraining mechanisms, including the markets, psychological constraints, and legal and regulatory requirements. The markets in the UK have sufficient strength to ensure that controlling shareholders do not disgruntle minority shareholders too extensively for fear of creating large-scale exit by minority investors and difficulties in garnering further investment at an acceptable price – creating a commensurate diminution in share price. However, as is evident from the travails of Sports Direct and dissatisfaction asserted by minority shareholders, those market constraints are not sufficient to eliminate much unwelcome conduct. In the absence of adequate market and psychological constraints, regulation has an important part to play.

This paper has set out certain specific deficiencies in current regulatory requirements ostensibly effected to constrain controlling shareholders. In particular, existing regulatory constraints can be enriched by: (i) strengthening (where a controlling shareholder is able to exercise greater than 50 per cent of the votes attached to shares in the company) the dual voting requirements to give independent shareholders a definitive veto right over the election and re-election of independent directors; and (ii) extending the range of transactions that should be disclosed to minority shareholders, and opined upon by the firm's sponsor, through expanding the definition of 'related-party' and dispensing with certain materiality thresholds in the presence of a controlling shareholder.[164]

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[164] In the context of attracting the proposed listing of Saudi Aramco to the LSE, the FCA has published a consultation on creating a new premium-listing category for sovereign controlled companies (FCA Consultation Paper CP17/21). Under the proposals, the sovereign controlling shareholder would not be considered to be a related-party under the Listing Rules, and the company would not be subject to certain of the enhanced controlling shareholder provisions that were implemented in May 2014 (including the aspects related to the dual vote on independent directors and relationship agreements outlined in this article). Although different considerations may apply to sovereign controlling shareholders specifically, based upon the

With such proposed regulatory changes, certain of the controversial acts carried out by Sports Direct may not have occurred or would, at least, have been subject to greater scrutiny; but at the same time such proposed changes would not be so astringent to deter benign controlling shareholders from listing their firms in the UK in the first place. With targeted and thoughtful amendments to regulation, the benevolent 'fat controller' of children's lore could become a source of optimism rather than a source of distrust in the UK listed company domain.

discussion set forth in this article, such a relaxation of the rules should certainly not be extended to controlling shareholder firms generally, and, in fact, the rules should instead be reinforced as specified herein.

Table A: Significant Opposition by Independent Shareholders to Director Re-elections

Company	Date of Vote	Controlling Shareholder ownership	Result of vote	Consequence
Georgia Healthcare Group plc	1 June 2017	64.21% as of 31 March 2017[165]	38.99% of independent shareholders voted against the re-election of Jacques Richier[166]	The board, in assessing such significant opposition, maintained that the director continued to act as an effective independent director
Schroders plc	28 April 2016	47.93% of the voting rights as of 31 December 2016[167]	11.8% of independent shareholders voted against the re-election of Lord Howarth of Penrith, the senior independent director[168]	No significant corporate governance changes initiated
Hochschild Mining plc	12 May 2017	54.03% as of 31 December 2016[169]	28.03% of independent shareholders voted against the re-election of Jorge Born Jr.[170]	The board concluded that the director still continued to act as an effective independent non-executive even though his service exceeded nine years

165 Annual Report and Accounts of Georgia Healthcare Group plc for the financial year ended 31 December 2016 at 119.
166 RNS number 9125G, 1 June 2017.
167 Annual Report and Accounts of Schroders plc for the financial year ended 31 December 2016 at 66.
168 RNS number 7084W, 28 April 2016.
169 Annual Report and Accounts of Hochschild Mining plc for the financial year ended 31 December 2016 at 54.
170 RNS number 0193F, 12 May 2017.

Company	Date of Vote	Controlling Shareholder ownership	Result of vote	Consequence
Fresnillo plc	4 May 2016	75% at the time of the vote[171]	29.87% of independent shareholders voted against the re-election of Charles Jacobs[172]	Company did not even acknowledge high voter discontent

171 Annual Report of Fresnillo plc for the year ended 31 December 2015 at 22, and the Annual Report of Fresnillo plc for the year ended 31 December 2016 at 26.

172 RNS number 1379X, 4 May 2016.